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TAGS: ECON EFIN ETRD IT EUN NATO
SUBJECT: SNAPSHOT OF ITALY'S ECONOMY BEFORE UPCOMING ELECTIONS

SUMMARY

¶1. Because of a marked decline in domestic demand and exports, the GOI has just decreased 2004 GDP growth estimates from 1.4 to 0.9-1.0 percent. A key economic ratio - budget deficit/GDP -- continues to climb upward, because the deficit is growing faster than the economy (as measured by GDP growth). The European Union, worried Italy's performance will deteriorate further to violate Stability and Growth Pact commitments, will delay an "early warning" to Italy regarding its budget deficit until after local and EU parliamentary elections in June. In return, Italy has agreed to five billion euros in spending cuts. We think there is enough fat in the budget to make these cuts without widespread reductions in public services. We also do not expect voter backlash over the spending cuts. However, combining these cuts with the recently announced plan to reduce taxes and implement pension reform will require skillful management by the Government. End Summary.

GDP Growth Forecasts Cut

¶2. The consensus forecast for 2004 GDP growth is 0.9-1.0 percent, down from previous predictions of 1.4 percent growth. This is a half percentage point below the expected GDP growth rate in the Euro area this year. The downward revision is due to a marked decline of domestic demand and exports during the fourth quarter of 2003, which translated into no growth for fourth quarter 2003 GDP from the previous quarter.

¶3. Italy's Central Institute of Statistics (Istat) released May 13 preliminary GDP growth data for first quarter 2004 that showed Italian GDP growth at 0.4 percent, compared to the first quarter of 2003 - a rate lower than that of the United States, France, or the UK. Istat also released industrial production data indicating a 0.5 percent decline in industrial production in the first quarter 2004, over the fourth quarter in 2003.

Domestic Demand and Exports: Lackluster Performance
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¶4. The disappointing fourth quarter 2003 results reflect the lackluster performances of domestic demand and exports. Only rising inventories prevented a more pronounced fall in GDP growth. The decline in domestic demand (i.e., a 0.4 percent quarter-on-quarter decline in household consumption, the first decline since 2002) is indicative of the current fragile state of consumer confidence. This deterioration of consumer confidence reflects concern over the employment outlook; perception of high inflation; the psychological fall-out from earlier financial scandals (Argentine bonds, Cirio, and Parmalat); and the sharp increase in oil prices.

¶5. Nor did the export sector perform well. Largely because of the Euro's appreciation, exports dropped by 3.8 percent from the previous quarter.

GOI Revises GDP Growth Forecasts

¶6. As a result of the less promising macroeconomic outlook for 2004, Treasury analysts are revising downward the official GOI assumptions for the 2004 budget that they used in late 2003. The GOI revised its GDP growth target estimate downward from 1.9 percent (a September 2003 estimate) to a more realistic, although still optimistic, 1.2 percent. (Note: GOI GDP growth estimates are not really forecasts, but rather assumptions and targets set during the budget preparation process to identify budget decisions necessary to reach certain Budget Deficit/GDP ratio and Debt/GDP ratio targets. End Note.)

¶7. The GOI will also revise upward the official estimated

target for the Budget Deficit/GDP ratio from 2.2 percent to 2.7-2.8 percent.

EU Commission Watching Italy's Deficit

¶8. Earlier this year, contrary to GOI estimates, the EU Commission estimated that Italy's deficit would, in fact, rise to 3.2 percent of GDP in 2004 and to four percent of GDP in 2005. For this reason, the European Commission had discussed issuing an early warning to Italy for possibly violating the three percent deficit/GDP ceiling, but then decided to postpone discussion and a decision until early July, after the mid-June European parliamentary elections.

¶9. In return, Italy agreed to a spending cut package of some Euro five billion, equal to about 0.4 percent of GDP. The spending cut package will be implemented through a decree law, approved by the Cabinet. Reportedly, consensus already exists within the Cabinet to approve the package. (Note: Decree laws go immediately into force, but the Parliament must approve them within sixty days. The Government's majority in Parliament means the measure, once introduced, is almost certain to be approved. End Note.) Finance Minister Tremonti called the Commission's postponement "a logical and natural solution."

At Least One Stimulus Proposal Remains: Tax Reform
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¶10. This is the year of local and EU parliamentary elections; and, while Finance Minister Tremonti will continue to have a dominant say in all spending decisions, we can expect Parliament and many Government ministers, especially Defense Minister Martino, to continue to urge additional spending. In addition, the GOI has just announced it will implement in 2005 the last, and most significant piece of its proposed tax reforms - to cut the current five personal income tax brackets to two: 33 percent for income over Euro 100,000 per year, and 23 percent for lower incomes. We expect the Cabinet decree law to leave this tax reform relatively untouched, since the Prime Minister promised this reform during his 2001 election campaign "Contract with Italy." Tax reform also will be sold to the public and Parliament as boosting consumption and domestic demand.

The Impact of Parmalat and Alitalia on the Budget
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¶11. Italy is now contending with crises in two major firms - the USD 18 billion Parmalat fraud, and the possibility of a failure of its flagship air carrier, Alitalia. Due to EU constraints on government subsidies, we do not expect a GOI bailout of either of the two corporate giants, and, thus, no impact on government spending.

¶12. In the case of Parmalat, there is no government guarantee of Parmalat bonds; most of the burden of restructuring Parmalat's debt falls on creditors' shoulders. According to the Bank of Italy, even the impact on the Italian banking sector will be limited. (Small Italian investors are the big losers in this scandal, with almost all Parmalat bonds sold by banks to individuals before the scandal was made public.) Italian bank exposure to Parmalat was some three billion euro at end-November 2003. With respect to Italy's ten largest banks, Parmalat loans were only equal to 2.3 percent of total assets. (Note: we do not know whether the banks had reserved against possible losses, or would take any losses out of current earnings. End Note.)

¶13. Regarding Alitalia, the solution now under discussion would not involve any direct GOI investment in the company - outside of a bridge loan to Alitalia, which the company must pay back. However, a solution could include GOI unemployment payments (80 percent of salary for one year) to a substantial number of Alitalia employees laid off.

The Trend in Wages

¶14. The econmy at large - and the GOI budget - will probablynot be further battered by any widespread call for wage increases this year. Analysts expect Italia wages to rise by no more than three percent in 004. In addition, many of the largest union conracts were already successfully negotiated -- pecefully -- in the last quarter of 2003: these inluded contracts in the insurance industry, the Naional Health System, and city transportation. In February 2003, a large contract in the publishingsector was signed, and just this week, FIAT reaced agreement with its workers at its southern Itly plant. That agreement provided for very modest salary increases spread out over the next eighteen months.

Comment

¶15. Up until the May 11 announcement of a "deal" with the EU on the possible issuance of an early warning to Italy, Finance Minister Tremonti had been working towards two sometimes conflicting goals: to raise languishing domestic demand and growth, and to resist pressure for increased spending that would push Italy's deficit clearly beyond the three percent EU limit. Tremonti now seems focused on controlling spending and the budget deficit in 2004. We do not know what spending cuts Tremonti plans in the GOI budget to slash Euro five billion, but we anticipate that enough fat can be found for this amount to be cut without causing wide-spread reduction in public services. Tremonti will try to sweeten any negative reaction to his budget cuts through simultaneous tax reductions. End Comment.
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